

# Privatization of Utility Systems

by Mr Robert D. Helwig



This article provides an overview of the new program—the process for privatizing utility systems—and some of the financial issues which will surely be encountered as utilities privatization goes into effect.

Coming on the heels of military housing privatization is the privatization of military utility systems. In the next few years, the Air Force intends to privatize its utility systems worldwide (water, wastewater, electrical, and natural gas), including those on Reserve and Air National Guard bases. Exceptions will be made for those systems required for unique security reasons or those which would be uneconomical to privatize.

The Air Force financial community will be called upon to review and certify economic analyses (EA) for over 400 utility systems—though often one EA will cover more than one system on a base. These EAs will in turn be submitted to Congress for project approval. This article provides an overview of the new program, the process for privatizing utility systems, and some of the financial issues which will surely be encountered as utilities privatization goes into effect.

## Program Overview

Legislation enacted as part of the Fiscal Year 1998 Defense Authorization Act, 10 USC 2688, provides the statutory authority to privatize Air Force utility systems. The statute authorizes the military Services to convey ownership of utility systems, including certain supporting real estate interests, to private districts, companies, or other entities. The new owner will operate the system and provide the utility service to the military installation for a service charge. As consideration for the conveyed system, the new operator must pay the military Service its fair market value, either as a lump sum or in the form of reduced charges for the utility service. The statute requires the military Services to use competitive procedures where possible to select purchasers of the systems. Congress must be notified 21 days before any system may be conveyed.

Utility systems are the structures and mechanisms for distributing a utility on the installation and should not be confused with the commodity itself. For example, a water utility system would include the pipes, but not the water running through the pipes. In most cases, the commodity can be purchased separately from the Services of the utility system provider. The four main types of systems to be privatized are electricity, natural gas, water, and wastewater; however, the legislation is broad enough to include other systems such as steam generation, chilled water, and heated water.

The Air Force has 640 utility systems in its inventory at 168 major and minor installations. Of this total, 78 systems are already privately owned, 98 have been identified as exempt, and 23 have been identified as being owned by other entities, such as host nations. This leaves 441 candidate systems to be privatized.

Unlike housing privatization, the military Services have been given little latitude in deciding whether or not to privatize utility systems. The Secretary of Defense's Reform Initiative, issued on 10 November 1997, directed the military Services to privatize all utilities by 1 January 2000, except where they were needed for unique security reasons or where it was uneconomical. Defense Reform Initiative Directive (DRID) #9, signed by the Deputy Secretary of Defense, formalized this requirement on 10 December 1997. The privatization deadline was later revised to 30 September 2003, by DRID #49, dated 23 December 1998. DRID #49 also established interim goals requiring all feasibility determinations to be complete by 30 September 2000, and all requests for proposals to be issued by 30 September 2001. DRID #49 stated that exemptions from privatization could be taken for unique security concerns or where it would be uneconomical; however, such exemptions should be rare and must be under the authority of the Secretary of the military department.

To meet this robust schedule, the Air Force has established a three-phase process to implement its privatization program and has hired a team of contractors to assist in implementing the program. These contractors are performing a majority of the technical tasks from feasibility analysis to project execution with oversight from Air Force functional areas such as civil engineering, contracting, general counsel, and financial management.

Phase One is the Preliminary Feasibility Assessment which defines the requirement and determines the feasibility of meeting the requirement through privatization. Phase One includes the Operational Impact and Risk Management (ORM) analysis to determine if the system is required for unique security reasons. Phase One also includes a preliminary economic analysis based upon a 25-year cash flow comparing the privatization alternative with the status quo government-owned alternative.

Phase Two is the Comprehensive Analysis in which the project is refined and the Request for Proposals (RFP) is developed. Phase Three is Project Implementation during which the RFP is issued and the private utility provider is selected. It is during Phase Three that the certified economic analysis is prepared, reflecting actual costs based upon the selected proposal.

#### Financial Issues

Two financial issues are of great concern because they are statutory mandates: the economic analysis and the requirement that the Air Force receive fair market consideration for conveyance of the system.

The statute states that a conveyance of a utility system may not be made until 21 days after an economic analysis is received by the appropriate Congressional committees. The economic analysis must be based upon accepted life-cycle costing procedures approved by the Secretary of Defense. Furthermore, it must satisfy a two-prong test. First, the long-term economic benefit of the conveyance to the United States must exceed the long-term economic cost of the conveyance to the United States. Second, the conveyance must reduce the long-term costs of the United States for utility services provided.

### Three-Phase Project

- Phase One

#### Preliminary Feasibility

#### Assessment

- Phase Two

#### Comprehensive

#### Analysis

- Phase Three

#### Project Implementation

## Privatization of Utility Systems (Continued...)

Generally, an economic analysis is a decision-making tool for making rational decisions among several alternatives. Under the utilities privatization statute, the economic analysis is the approval document submitted to Congress. For utilities privatization, only two alternatives are considered, the status quo and privatization. Usually EAs consider more than two alternatives—however, for utilities privatization, the effect of OSD policy is that only two alternatives need to be considered. The Air Force intends to satisfy the first prong of the test with a narrative concerning the long-term economic benefits of each privatization project. This narrative should reflect benefits derived from construction to correct system deficiencies, timely renewal and replacement, and improved operations and maintenance.

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The life-cycle costing procedures approved by the Secretary of Defense are reflected in DRID #49. It states that the economic analysis must take into account the “should” costs of operation, maintenance, and system improvements, i.e., the costs which would be incurred by the Department if the systems were operated and maintained in accordance with accepted industry practices and all applicable legal and regulatory requirements. Consideration of “should” costs means that costs which have not actually been incurred in the past will be included in the economic analysis. This approach obviously risks inclusion of speculative “wish list” costs and conscientious oversight will be required to ensure an accurate reflection of the “should” costs included in the status quo alternative.

Given the newness of the program and the lack of empirical data in the Phase One Feasibility Determination, a 20 percent margin is employed in reaching the go-ahead decision. That is to say, if the costs of privatization are within 20 percent of the status quo alternative, the project will proceed to the Phase Two Comprehensive Analysis. The margin is intended to make sure that good candidate projects are not excluded based upon faulty financial assumptions. This may result in some Phase Three reversals where proposed long-term privatization costs actually are greater than the long-term status quo costs.

The other important financial issue is the requirement for fair market value consideration. The statute states that the Secretary shall require as consideration for the conveyance an amount equal to the fair market value (as determined by the Service Secretary) of the conveyed system. Such consideration may take the form of a lump sum payment or a reduction in charges for the utility services provided. Lump sum payments are credited at the election of the Secretary to (a) an appropriation for the procurement of the same utility services, (b) an appropriation for carrying out energy savings or water conservation projects, or (c) an appropriation for improvements in other utility systems.

A question immediately arises as to the actual value of the utility systems which are proposed for conveyance to the private sector. Such value will be affected by many factors including (1) the condition of the existing system, (2) the total available market which can be served by the system, (3) the additional income to the provider generated by the system, (4) the operational requirements placed on the system operator to satisfy military requirements, and (5) the ultimate allocation of economic risk stemming from terms and conditions connected to the conveyance and service contracts.

In Phase One, the preliminary economic analysis employs the concept of replacement costs new less depreciation (RCNLD) to derive a value of the system conveyed. This means that the value of the system would be the cost to replace the system components, depreciated to reflect the life of the system.

This gives some understanding of the system's value to the government, but it is not necessarily the same value the market will place on it.

Where competitive procedures are employed and there are numerous proposers, the Air Force can have a high degree of confidence that the market has appropriately priced the system and that the Air Force is receiving fair market consideration for the conveyance. Where the selection is based on a sole source, usually occurring in a regulated environment, methods must be developed to ensure that the Air Force is receiving fair market consideration for the system.

Calculation of the consideration should be easily accomplished where payment is made in a lump sum. Where consideration is reflected in a reduction of utility system charges, it may be necessary to establish a benchmark as to what the charge would be without conveyance of the system and what is the charge proposed including conveyance of the system. Where the system is in degraded condition and where the service market is limited to the installation, the fair market consideration may not be substantial.

### Conclusion

Utilities privatization is like a fast-moving train. One hundred and twenty-three systems have been identified to go on to the Phase Two Comprehensive Analysis and RFP development. Like the privatization of housing, the privatization of utilities reflects a major paradigm shift in the way the Air Force does business. It is a shift from owning and controlling assets in-house to managing the supply of privately provided services. Under the new paradigm, the financial community will have an enormous role to play, both in evaluating the merits of privatization alternatives and in ensuring that the privatization deals that the Air Force enters into are financially sound.



## About the Author

Mr Robert Helwig is currently the Deputy Director of Competitive Sourcing and Privatization, Deputy Under Secretary of Defense for Installations. He has BAs in Political Science and French from the California State University at Long Beach; an MA in International Policy from the Monterey Institute of International Studies; and a JD from the National Law Center, George Washington University. Prior to assuming his current position he was a financial analyst for the Deputy Assistant Secretary, Cost and Economics (SAF/FMC) where he was actively involved in both housing and utilities privatization. Before coming to SAF/FMC he worked for the Air Force Civil Engineer and was one of the original members of the Housing Revitalization Support Office (HRSO), established under the Secretary of Defense for Industrial Affairs and Installations.